Moscow Financial Weekly

For the Period February 25-March 22, 2002

Treasury Attache's office, US Embassy Moscow

Highlights This Week

- **MinFin provides clarity on external debt**
- **The new CBR Chairman hits the right notes**
- **The RTS on a roll**
- **Weekly focus: SME Development in the Urals**

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R31.1168	0.15	3.25
Monetary Base*	R699.9 bln	0.07	-1.21***
CPI	NA	NA	4.3
International Reserves*	$37.4 bln	1.08	2.47
RTS Index (end of week)	347.55	2.14	33.65
Refinancing rate	25	0	0

*For week prior

** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

According to the Deputy Finance Minister Sergei Kolotykhin, Russia has achieved a considerable progress in decreasing its overall debt last year. The external debt was down from $143.3 billion to $130.1 billion as of the beginning of 2002. It is expected that by January1, 2003 the debt would be down to $120-122 billion. These numbers still leave some questions as to the true exposure since debt held by state banks or othr related entities may not represent a true liability. Nevertheless this clears up what has been a series of contradictory statements regarding Russia's external debt. The decrease in the external debt may be accompanied by an increased internal debt. As noted in a recent focus piece, some officials have been arguing that the government should be more active in this segment of the market to support the financial system and monetary policy.

Form of debt	***$ bln***
Paris Club debt	41.2
Debt to countries not participating in Paris Club	3.7
Debt to former USSR Republics and Yugoslavia	12.2
Coomercial debt	6.5
Eurobonds and Minifin bonds	45.2
Debt to the international financial institutions	14.9
Debt on CBR credits	6.4

Total	130.1

Kolotukhin also recently remarked that he is not sure whether the government needs the $2 billion Eurobond issue planned in the budget, given the favorable fiscal situation and lower debt payments. Following a recent information-gathering mission to London and the US, he said he is not convinced that the market situation is not favorable enough.

The State Statistics Committee reported that the 2001 federal budget surplus amount to R 265 billion, or 2.93% of GDP, up from R102.9 billion in 2000. Revenues totaled R 1.59 trillion or 17.6 percent of GDP, while spending was R1.33 trillion or 14.7 percent of GDP. The strong surplus is explained by continued high oil prices throughout most of 2001. In February 2002, the federal budget posted a R 15.3 billion deficit or 1.1 percent of GDP, with tax revenue collection totaling R 96.6 billion, compared to a target of R98 billion. The deficit in February was the result of a R32.5 billion payment to the Paris Club, which was mostly interest and therefore a direct budget (as opposed to foreign financing) hit. The estimated tax revenue was based on the budget estimates for $23.5 per barrel oil price, while the actual average price is closer to $18. However, year to date, the budget has posted a surplus of R 33.3 billion or 2.3 percent of GDP, and gross revenues remain on track.

Foreign investment in 2001 was up 30.1 percent year on year at $14.26 billion, as reported by the State Statistics committee. Direct foreign investment fell by 10.1% year on year at $3.98 billion, with other foreign investments (including both porfolio and state trade credits) totaling $9.82 billion. The major foreign investors are Germany, USA, and Cyprus, in that order.

According to State Customs Committee preliminary statistics, the external trade surplus was $3.9 billion in January, vs. $5.8 billion in January 2001, a 30% decrease. Exports continued to fall and were down to $6.4 billion (21.9% y-o-y decrease). Imports were up again in January and totaled $2.5 billion (4.7% increase). For the year, the 2001 trade surplus was $49.65 billion, down from $60.70 billion in 2000.

Industrial production was up 2.1% y-o-y during the first 2 months of the year. The highest growth was recorded in medical industry (32%), non-ferrous metallurgy (9%), and the food industry (8.5%). Growth is limited by lower oil prices and a continuation in the real appreciation of the ruble.

Banking sector

On March 20 the State Duma passed a resolution appointing First Deputy Finance Minister Sergey Ignatiev on the post of the Chairman of the Bank of Russia. The decision was made on the basis of suggestion by President Putin. On March 15 President Putin nominated Ignatiev to the post in connection with resignation of Viktor Geraschenko.

Ignatiev's statements have emphasized continuity, saying that the monetary, exchange rate and credit policies of the CBR had been "adequate to the situation" and he was not going to introduce "any revolutionary changes". However, among the priorities for the CBR Ignatiev mentioned strengthening bank supervision, adopting IAS and establishing a system of deposit insurance. The mechanism for guaranteeing deposits should be introduced in such a way that "no additional risks are created", Ignatiev stressed. He said that currency regulation "should be liberalized, but gradually". Currency controls may be eliminated, he said, but not sooner than 5 years from now. In H2 2002 Ignatiev wants to reconsider, together with the GOR, the issue of reducing the norm for mandatory sale of export earnings, currently at 50%. As for foreign reserves, according to Ignatiev they should grow in the longer run, but while oil prices are on the lower side there is no need to speed up their accumulation. Ignatiev assured that the CBR would divest of the "roszagranbanks" -its foreign daughter banks - by January 1, 2003, the deadline set by the GOR. He also emphasized that the GOR and the CBR should increase control over Sberbank's policies and financial standing. Finally, he said that the refinancing rate, which stood unchanged at 25% since November 2000, would probably be reduced this year.

As for the man his is replacing, exactly as in the two previous cases when he had to vacate the post of Central Bank Chairman, Viktor Geraschenko did not quit the Bank, but stayed on the position of economic advisor with the CBR Research Institute. Geraschenko said in an interview that he would also like to sit on the Supervisory Board of Sberbank. Ironically, he also reportedly intends to secure a seat in the renewed National Banking Council "provided its new status does not significantly confine the independence of the Bank of Russia". He had been fiercely resisting all attempts to upgrade the status of NBC until the very moment he resigned.

The XII Congress of the Association of Russian Banks will take place in Moscow on April 24. Newly appointed Chairman Ignatiev will present CBR's monetary and credit policies there. ARB Chairman Yegorov will report on the role of ARB in formulation and implementation of the strategy for banking sector development. The congress will also discuss the newly drafted banking ethics code and issues related to implementation of the anti money-laundering bill.

The bill on deposit guarantees will be considered by the Government by the end of March and then within a month submitted to the Duma, Arkady Dvorkovich, Deputy Minister of Economic Development and Trade, told the conference "Attracting Banking Capital to the Russian Economy" that took place in Moscow on March 20-21. The bill, Dvorkovich stressed, "would eliminate Sberbank's de-facto monopolistic guarantee for private deposits and provide conditions for diversifying deposits in the future". He hopes the bill would be passed into a law by the end of the year. However, Alexander Shokhin, Chairman of the Duma Committee for Credit Organizations and Financial Markets, who also wants to have the law in place as soon as possible, was displeased by the Government's "excess activity", pointing out that this would be already the fourth draft presented to the Duma and all of them "are conceptually inconsistent with each other". According to Shokhin, there is no need to create a new state agency to manage the funds of the deposit guaranteeing system: it could be done either by an organization of professional market participants, or by the Agency for Restructuring Credit Organizations. He is also strongly against the voluntary stage proposed by Dvorkovich. Shokhin believes that from the very moment the system of deposit guarantees is launched only those banks that participate in the system should be allowed to take private deposits. He thinks that adoption of IAS and maintaining 10% capital adequacy might be a sufficient condition for any bank to be admitted to the system. Another issue raised by Shokhin is the deposit amount covered by guarantees. The current draft provides for "step down" schedule: only very small deposits would be reimbursed in full in case of bank failure, the larger the deposit, the smaller portion of it would be repaid. Shokhin advocates a scheme where all deposits up to a reasonable limit would be repaid in full.

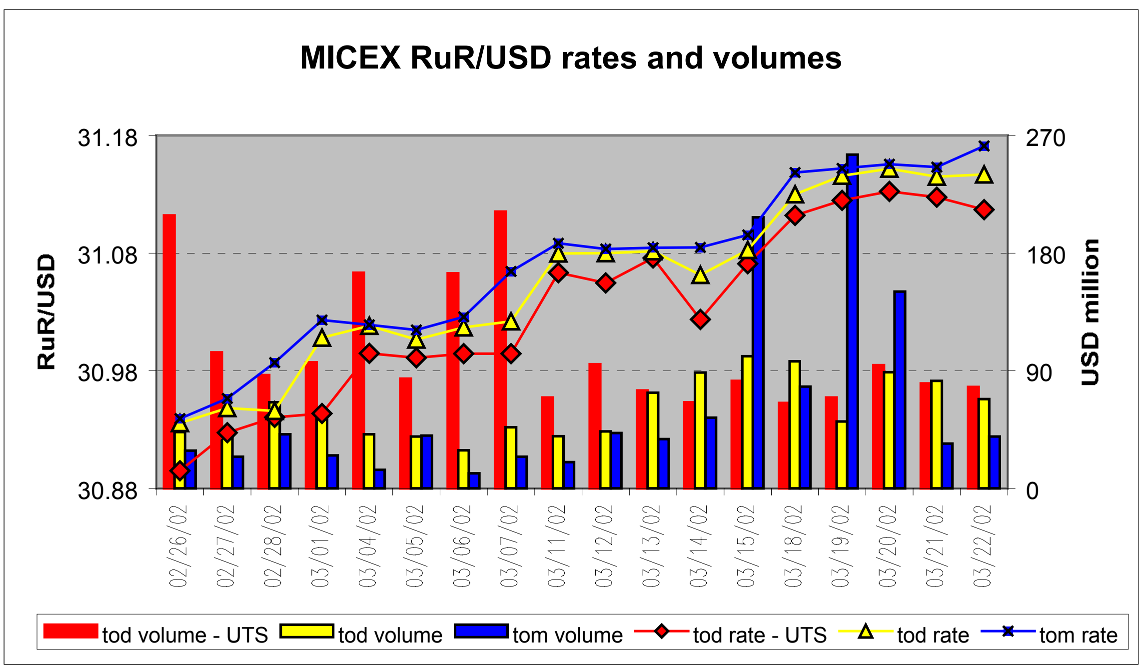
<u>Financial markets</u>

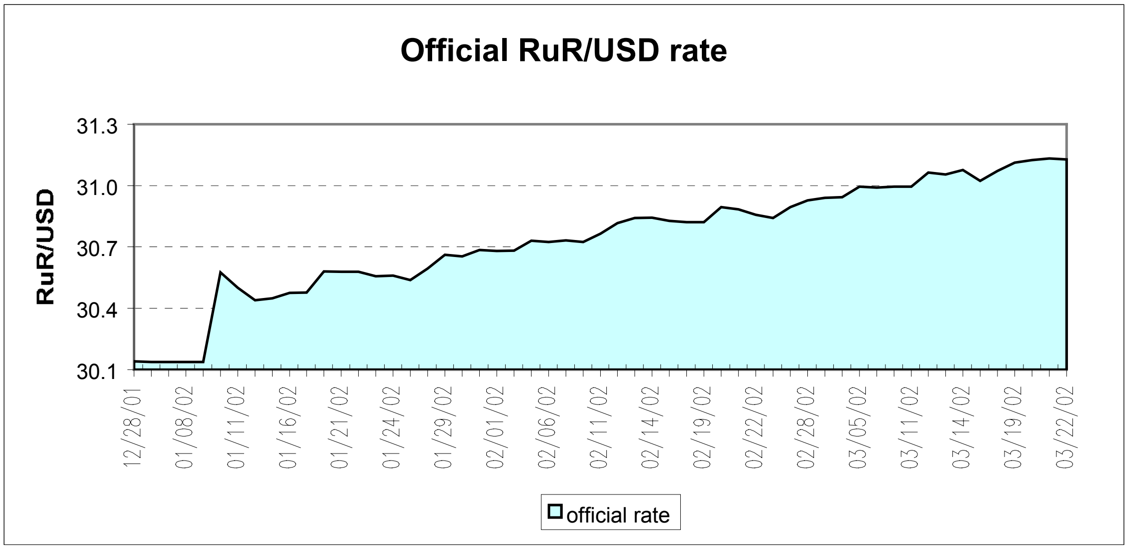
<u>Forex Market</u>

During the first half of March the CBR had to intervene several times with up to $200 million a day in order to smoothen ruble depreciation. However, constantly rising oil prices allowed it to resume building up reserves.

The last week was the first week after the resignation of Viktor Geraschenko and there were some fears of ruble devaluation expressed in the media over the weekend. However, on Monday the ruble continued depreciating at exactly the same pace as on previous trading day, with the CBR indicating its presence in the market with just around $20 million sold. In the next two days ruble depreciation slowed down and in the last two days of the week the ruble was already firming, all of it without any interference from the CBR.

For the four last weeks the ruble weakened 0.89%, while for the last one - just 0.15%, closing in the UTS on Friday at 31.1168/$. Last week MICEX weekly trade volumes were $387.08 million, $387.35 million and $557.50 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.

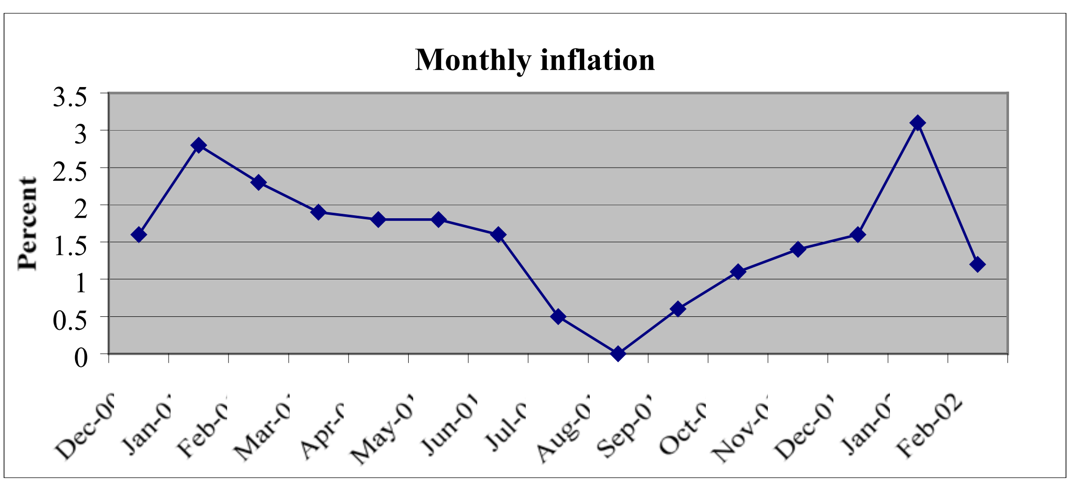




Prices

Prices were up 1.2% in February, compared to January's 3.1%. At an annualized rate, February inflation translates into 15.3%. The decrease in the inflation dynamics can be attributed partially to the glut of oil on the domestic market - gasoline prices were down by 2.4% last month. The effect of last year's December fiscal emissions are also dissipating. Services prices that include natural monopolies tariffs are still the major factor pushing inflation - these were up by 2.7%. Prices for foodstuffs and for non-foodstuffs were up by 0.9% and 0.8% respectively.

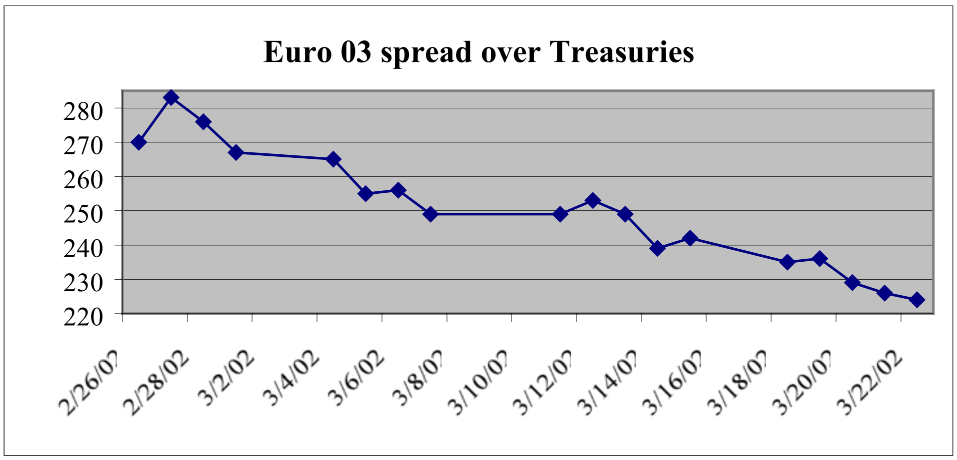
Inflation for the first 11 days of March amounted to 0.4 percent, and 0.2 percent from March 12-18. Both Goskomstat and MEDT estimate inflation for 1.2 percent in March, on par with February. However, this estimate does not seem to take in account new electricity tariff increases from March 1, as well as further implementation in communal housing tariffs.

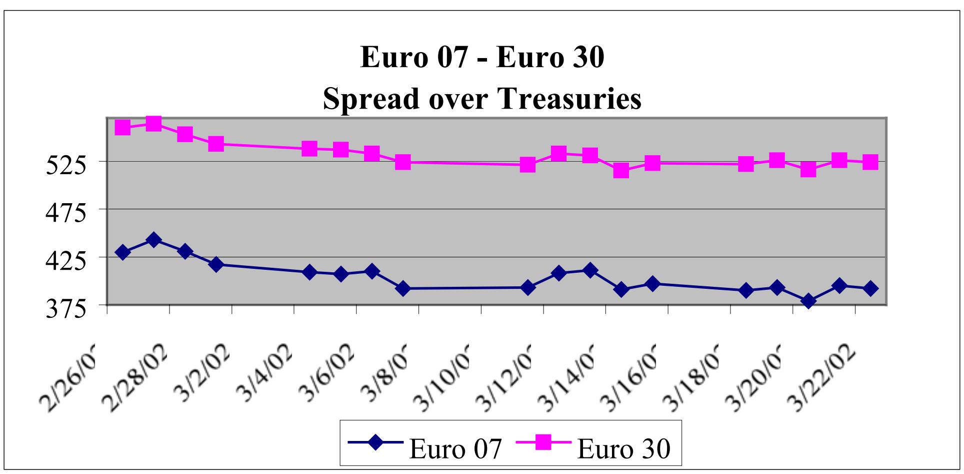


Eurobonds

During the first seven days in March, prices in the Russian Eurobond market rose quite impressively, with longer-maturity issues reaching their record maximums (Euro-30, Euro-28). The market was fueled by higher oil prices, MinFin's confirmation of a lower debt stock, and more positive figures on US growth at the end of 2001. However, growth slowed or was flat over the following two weeks. Early in the week of March 18th, the market was slightly higher following the news about Central Bank Chairman Gerachenko's resignation, but growth was tempered as participants awaited interest rate news from the US Federal Reserve meeting. Later in the week the market was marginally down or flat, primarily due to external factors (political factors in Latin America as well as new issues in Bulgaria, Uruguay and Chile.)

MICEX and RTS recently announced plans to begin trading in local Eurobonds. MICEX was first to announce in early March its plans to begin trading Eurobonds. Soon after, the RTS announced its plans to launch trading in sovereign Eurobonds and corporate ruble bonds in April 2002.

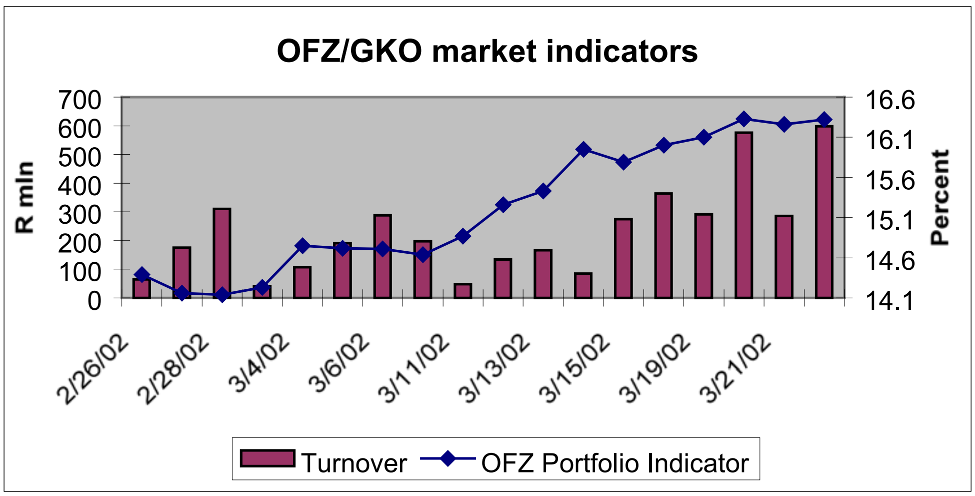




Interest/Bond Market

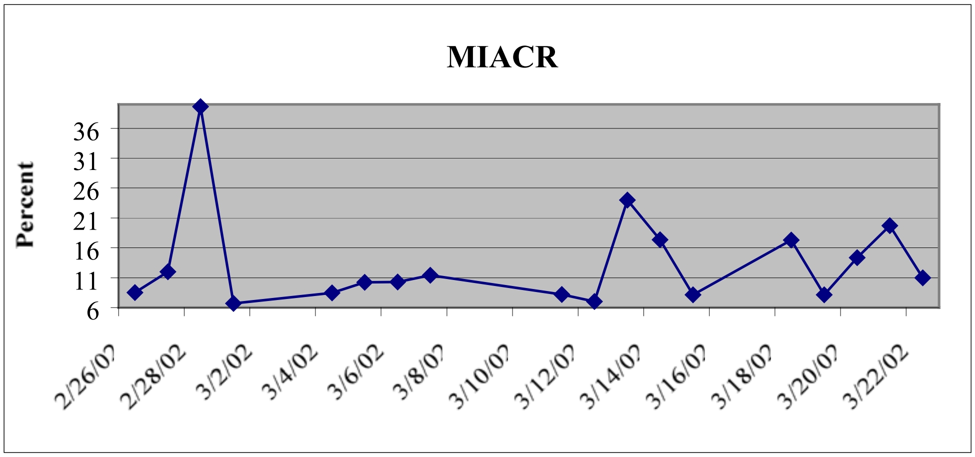
Bonds/Bills

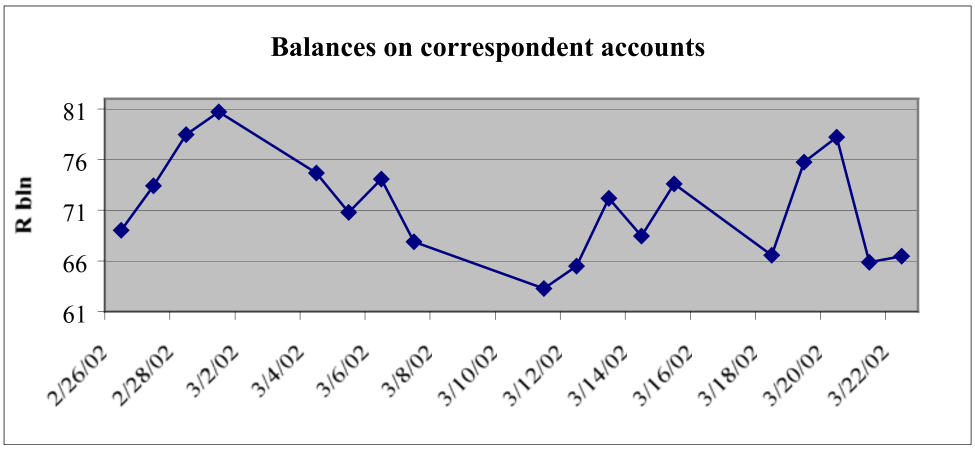
During the last week of February, the tight ruble liquidity situation forced banks to raise rubles by selling OFZ/GKO paper, causing prices to go down at the end of the week. Prices were also depressed on the expectation that at the upcoming two auctions MinFin would offer a significant premium. Trade volumes were very low. On March 13 MinFin changed its offer from 6 month to 8 month GKOs with an average yield of 15.22 percent. On March 20, Min Fin offered its longest term instrument to date -- 3.5 years -- at an average yield of 17.9 percent . Both auctions illustrated the recent change in debt policy to elongate the issues and offer yields more attractive to market participants. Later in the week of March 18, however, the GKO-OFZ market posted fresh losses due to the higher yields recently offered as well as continued tight ruble liquidity.



Overnight rates

The "end-of-the month" factor kept rubles scarce for most of the last week of February. Overnight rates were as high as 80% p.a. (MIACR) on the last day of the month, going down only by the end of the day, but still being higher than average - 40% p.a. On March 1 the situation calmed down - overnight rates were down to 2-5% p.a. by the end of the day and balances on banks' correspondent accounts were up to R80.7 billion, bringing the relief to the market. During the week of March 18 overnight rates were fluctuating around 10% - higher than the average level due to demand for rubles from banks which had to fill obligatory reserves funds. Balances on correspondent accounts were average, and no sharp ruble shortage on the market was observed.



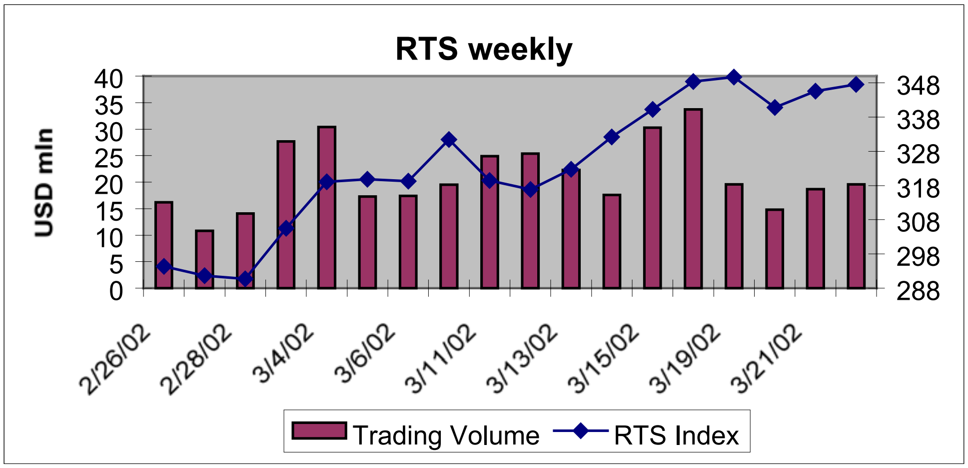


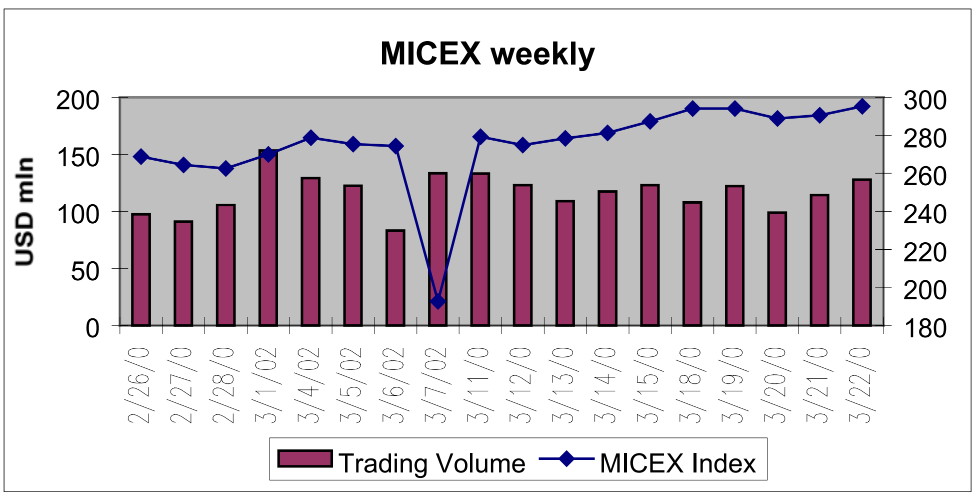
Stock Market

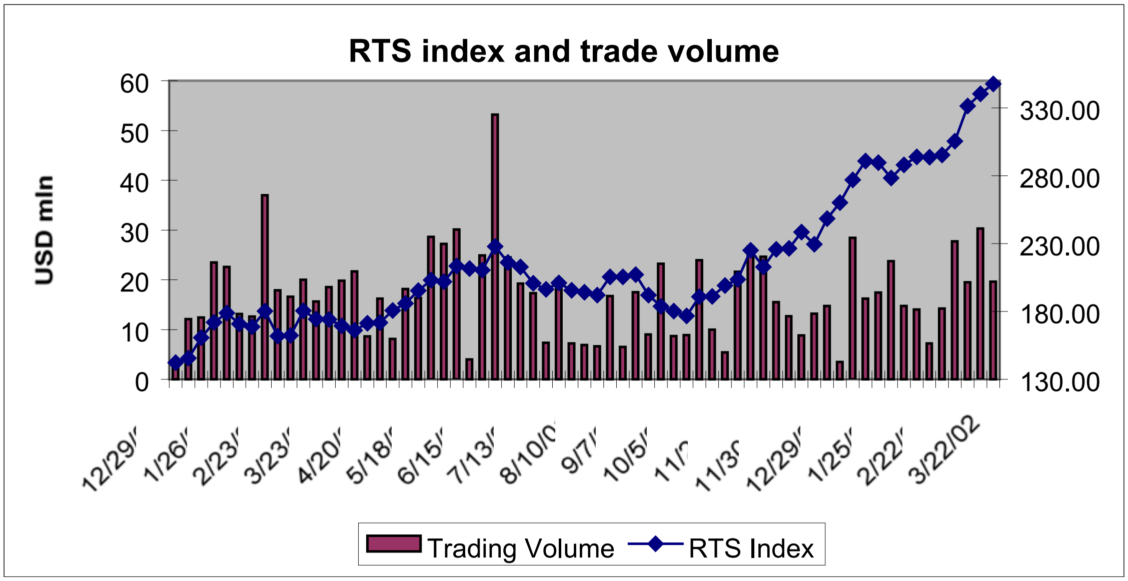
The last week of February was quite a success for the Russian stock market - the RTS index was up by 3.34% for this week, piercing through the important mark of 300 and stopping at 305.5. The market actually opened down on Monday and continued to slip through Thursday on low volumes. One of the main negative news was low net income of Surgutneftegaz and, therefore, low dividends - common shares of the company were down by 3.2% and preferreds - by 5.6%, dragging the market down. On Friday, the situation was reversed - the market was sharply up (by 5.1%) on quite a high volume of $28 million. The spike is explained by the inflow of foreign money (which was absent in the beginning of the week) as well as activated Russian buying.

During the second week (March 4-7) the market opened up and during the following two trade sessions the RTS index was fluctuating near 320 points on increased trade volumes from continued inflow of the foreign money. During the last trade session the market was sharply up and ended at 331.4. The RTS was up by 8.49% for the week in dollar terms.

The final two weeks observed showed renewed growth, with the benchmark RTS index hitting 340 by March 15, fueled by improved outlook for oil prices and the OPEC decision to stick to its reduced quotas of 2Q02. The announcement of Gerachenko's resignation sparked a 2.4% increase in the RTS on March 18 to 348 with a very strong volume of $33 million. Satisfactory industrial production figures added to positive market sentiment. Trading was muted on Tuesday, and took a dive on Wednesday on the government decision to extend the crude export curbs of 150 kbd into 2Q02. Performance was mixed on Thursday and Friday, with the RTS closing up 2.1 percent for the week.



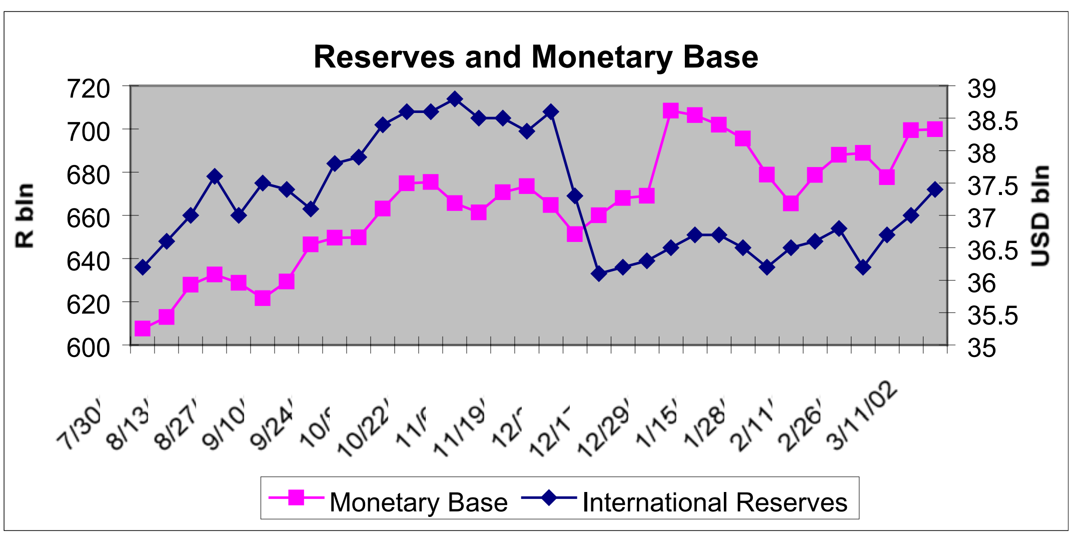




International Reserves and Monetary Base

International reserves were down by as much as $600 million decreasing to $36.2 level during the third week of February. This was 0.82% lower than in the beginning of the year. The decrease was mostly due to the external debt payments by the Finance Ministry and CBR interventions on the domestic currency market to support the ruble. However, during the last 3 weeks the reserves continuously recovered and reached $37.4 level by the middle of March. This is $900 million higher than in the beginning of the year.

The monetary base decreased by R11.2 billion during the last week of February and then grew by R22.2 billion to R699.8 billion in the weeks since then. It still remains R8.6 billion lower than it was in the beginning of the year after the seasonal spike.



SME Development in the Urals: Grass growing amid the smokestacks

The first thing a guest of the U.S. Consulate receives upon arrival in Ekaterinburg is what they call a "krisha card" (krisha being Russian for roof, ie. protection racket). The card essentially says that you have the diplomatic protection of the consulate and any policeman or thug that messes with you faces the full wrath of the U.S and Russian federal authorities. Nice to have, but for one arriving to check out the small and medium business sector, not a good sign.

Nevertheless, a recent trip to the Ural region - Ekatrinburg and Chelyabinsk – revealed a remarkable amount of vitality in the SME sector. Growth, however, seemed to driven by trickle down from prosperity in the large extractive industries rather than the impact of any recent reforms or fundamental changes to the business environment. Organized crime - both in the form of classic racketeering and more "official" incarnations - continues unabated. The only caveat may be that that the main organized crime groups have gone into so many legitimate businesses and are so flush with cash that they have less time to squeeze small entrepreneurs for their pennies. Credit also remains a problem though perhaps improving. Banks report that they are having to focus more on SMEs and the retail market as their big clients are doing more of their basic cash management and internal intermediation in-house.

This situation can be seen as the glass being either half full or half empty. On the positive side, if small business can grow despite the continuing burden of corrupt regulation, organized crime, very limited credit resources and the usual host of other problems, then it holds the potential for real dynamism when reforms actually take hold. The opposite view is that since small business has risen only as an adjunct of the post-crisis boom from high oil prices and a weak ruble, its foundation is weak. If competitiveness of the larger businesses wanes (and there seems to be only spotty evidence of fundamental restructuring going on at these companies) then SMEs would not be able to fill in as an engine of growth.

The burden on small business

None of those we talked to, including the government, reported any positive impact of the new federal regulatory law passed last year. The law is supposed to limit inspections to once every two years and gives businesses rights to resist corruption. In practice regulatory bodies for things like sanitation or fire, as well as the police, refuse to accept that they are covered by the law, though they clearly are. They apparently have received no direct orders to comply and there is no punishment mechanism, so they have continued with business as usual. And this means business in the literal sense. Many inspectors own the companies that test or fix the problems the inspectors so meticulously point out. There is apparently a move afoot by the President's Representative in the region (the "Polpred") to call agencies to account for their non-compliance with the law and possibly to set up a dispute resolution mechanism. However there were few hopes that this would improve things in the short term.

In terms of the burden of real organized crime the picture is a bit more murky. From the period 1992-98 a battle raged in Ekatrinburg between the two main gangs – the Centralny and the Uralmash (not to be confused with the Uralmash company). The results of this battle can be seen at the Centralny cemetery, where a row of elaborate funerary monuments chronicle the gang's demise, with etched renditions of the former gangsters clutching their Mercedes key for all eternity. While this makes for a rather unique tourist attraction, the broader result has been that the Uralmash group as had a relative free reign

to enter into nominally legitimate activities. It has built a new high-quality hotel, is supposedly behind a good portion of the high-end apartment construction going on in Ekatrinburg, and its head regularly runs for various elective offices without hiding his affiliations. (He hasn't won yet though). As mentioned above, this may provide more room for small businesses to operate under the radar screen of organized crime. It also has the feel of watching America's robber baron era play out in fast motion as the rascals begin to go legit. Still, overall, the spreading tentacles of organized cannot be positive for sustained growth.

Unfortunately it is hard to quantify the effects of all this given the nonsensical data on SMEs provided by Goskomstat. According to these data, the number of small businesses in Sverdlovsk Region, where Ekatrinburg is located, fell 18% in 1999, rose 22% the following year and then fell 32% last year. One could find reasons for these swings, such as SMEs de-registering as businesses in 2001 so as to qualify for the lower personal income tax rate, except that in Chelyabinsk just down the road the numbers are fairly steady. The statistics also bear no resemblance to the growth in trade and service firms that is obvious to all who live in the area.

Credit still a problem but some signs of improvement

It is worth noting to start with that we did not talk with any small business that had ever received credit from a bank. Given our small sample size this may not discredit the more positive trends we heard from bankers themselves but does highlight the basic situation: banks still play a very small role in the economy outside of crediting larger clients. That said, the EBRD's SME lending program ranks the Urals as its second most active region. It reports a fairly high proportion of larger loans (the maximum for the program is $500,000) for production operations. Other banks that call themselves SME lenders also claimed growth in their portfolios of 30-50% last year, much of it in trade and construction area. These banks clearly would prefer to lend to larger clients if they could, but are limited because of low capital, which in the cases we saw was less than $2M. Low capital did not however seem to limit in any way the banks' own construction budgets. They all occupied premises which belied their supposedly limited resources for lending.

Talking to the branches of large Moscow banks would indicate that having to do SME lending may not be such a bad thing. These banks were actively looking to expand their retail and SME business, first as a source of longer-term deposit financing, but also as a new market. They reported that large clients were increasingly sophisticated in managing their cash and thus large corporate deposits were falling despite higher profits. They also complained about competition from regional bank consortia lending to their larger clients. This was an odd complaint: the big banks argued that such lending was far less efficient than a single large lender, but were less clear about why the market would not sort out this problem in their favor. The best they could come up with was that large companies preferred smaller, weaker creditors to whom they could dictate terms. It was less clear why companies would be willing to pay significantly higher rates for this or why small banks would lend below cost. If nothing else, the contempt with which these large banks viewed small banks underscores the divisions in the banking industry that were so apparent in the recent debate over minimum capital standards.

A final, and uplifting, perspective on the credit scene came from a non-bank credit cooperative. It was by far the busiest lending establishment we visited, if the shabbiest. The organization funds start-up businesses for people referred to it by the city unemployment agency with loans from $40-$2000. It had 2000 members, a $200,000 portfolio and has been operating without subsidies for 8 years. It lends without collateral but requires borrowers to have guarantees from other members. It has a roughly 8% bad debt ratio, which is worse than the EBRD's SME program but apparently standard for such cooperatives. It is audited by a credit cooperative SRO once a year but is otherwise unregulated. One's initial reaction to this simple but obviously effective institution is, "Why aren't these things all over the place?" The fact is, however, that this is the only one in the city. There apparently had been upwards of 50 before the 1998 crisis but all but this one went bust. According to the owner, the rest mostly had been used for real estate and securities speculation. Unfortunately, there is no corporate form that is a magic bullet for forcing good behavior. The better question is why more dedicated and honest people like the owner of this cooperative aren't able to replicate this model.

Is SME growth sustainable?

The Urals economy continues to be driven by its industrial behemoths, just as it was under the Soviet Union. Right now times are good, but for sustained growth, big companies will have to restructure to achieve higher levels of productivity. In other transition countries, the process of large firms shedding non-core assets and rationalizing production opened up huge opportunities for new business to take over assets and become suppliers to the large plants. This in turn created further demand for other new business, which became the engine that drove the economy. While there certainly are cases of large firms in the Urals taking advantage of the current environment to become more competitive, this did not appear to be pervasive. Thus the economic platform for a real surge in the SME sector is not as strong as it good be. The hope for sustained growth comes from the implementation of structural reforms, both the ones that can reduce the burdens on SME directly and the ones that drive competition (and thus restructuring) among large firms. The GOR has shown it can pass reform legislation, but the challenge is to make it stick in places like the Urals. A closer look shows what a challenge that will be.

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS fix (rounded) becomes the "official" ruble rate for the next day. "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. **INTEREST RATES**: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. **STOCK INDICES**: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. **INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION** represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. **MONETARY BASE** (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.